Models of Islamic Microfinance

11.1 Conventional and Islamic microfinance

The Millennium Declaration 2000 is evidence of the unanimous recognition for broad based growth and inclusive development, with a special focus on poverty alleviation as the main goal. Financial exclusion is considered to be the major inhibiting factor towards improving the social status of the masses, and microfinance in this regard has emerged as one of the most effective tools to break the vicious circle of poverty, and induce financial inclusion. Consequently microfinance, the history of which can be traced back to the 60's and 70's, started gaining popularity as an efficient strategy to reduce poverty since the advent of the new millennium, resulting in an increasing number of microfinance clients all across the globe. Many research studies praised the positive economic and social impact of microfinance programmes; however, a significant portion of research and literature shows that microfinance has met with limited success in bringing sustainability in the social uplift of its clients. It has been proven that it is not only the financing gap, but the lack of social intermediation which is a major hurdle towards improving the social status of those below the poverty line. Asyraf Dusuki states "Social intermediation is the process in which investments are made in the development of both human resources and institutional capital with the aim of increasing self-reliance of marginalised groups, preparing them to engage in formal financial intermediation."[1] Lacunas are then exacerbated by a major failure of conventional microfinance: its inability to ensure the end use of microfinance loans, and target the abject poor. Ensuring the end use in microfinance becomes critically important, as any consumption use versus the intended productive use of microfinance loans has great potential to take the poor into a debt spiral instead of uplifting them from poverty. Against the backdrop of limitations of conventional microfinance, the inherent strengths of the Islamic financial system - that of ensuring asset based real economic activity, vigilant monitoring and enabling poor to empower themselves - lends itself comfortably for the creation of a strong nexus with microfinance.

By targeting the limitations of conventional microfinance, Islamic microfinance can play a more effective role in poverty reduction. The relatively higher probability of success of Islamic microfinance in targeting poverty lies in the nature of Islamic financing contracts, which make sure that the poor get the intended productive real goods and services, and their potential effective use becomes instrumental in bringing the poor out of the poverty trap. Also, the ultimate goals of Islamic finance is to help the poor, ensure equitable distribution of wealth and enhance social welfare, while the commercial aspect dictates generation of profit through targeting the underserved segment, making them contributors to economic growth and development . This obligates Islamic microfinance institutions (MFIs) to consider the abject poor as a target client, and also to monitor and supervise the use of financing thus minimising the operational inefficiencies of conventional microfinance, making its positive impact sustainable. This advantage of Islamic microfinance, of being more effective and sustainable, lies in its structure which is fundamentally different from the structure of conventional microfinance.

Another persuasive argument for developing Islamic microfinance is belief sensitive financial exclusion. One third of the world's poor population is Muslim, and various surveys conducted by credible organisations, including the Consultative Group to Assist the Poor (CGAP) and International Finance Corporation (IFC), have indicated that a significant percentage of microfinance clients showed preference for Shari'a compliant microfinance.[2] Therefore, the confluence of these two sectors (Islamic finance and microfinance) can jointly accelerate the pace to meet the target of reducing

[1] Dusuki, A.W. (2008)" Banking for the Poor: The Role of Islamic Banking in Microfinance Initiatives." Humanomics, Vol. 24 (1), pp.49 - 66

[2] Khalid, M. (2011), " Building a Successful Business Model for Islamic Microfinance", The Consultative Group to Assist the Poor (CGAP)

poverty and enhancing social welfare.

Conventional MFIs rely on four main models: (i) Grameen Bank (Group Based Lending) Model (ii) Village Model (iii) Credit Union and (iv) Self-Help Groups, which are not in conflict with fundamentals of Islamic microfinance hence there is no need to reinvent the wheel. However, there are differences in products and strategies of both industries, through which financial access is extended to a financially deprived segment. It is important to mention that marginalised groups of society also need various types of financial services including credit, saving, leasing and insurance.

Following Mohammed Obaidullah and Tariqullah Khan's study on Islamic microfinance, the four models can be described as follows:[3]

Grameen Bank Model (Group Lending): This is the leading and most popular model. The model operates on group based lending where members of the group act as collateral by guaranteeing each other and therefore minimising the risk of default .The most successful Shari'a compliant Grameen Bank Model is present in Bangladesh.

Village Bank Model: The MFI establishes a village bank containing approximately thirty members, and also injects capital for forward financing. The members of the village bank extend individual loans and repayment of those loans is mostly on a weekly basis. After four months the village bank pays back the capital along with profit to the MFI. Subsequent loans are subject to the repayment ability of the village bank, while loan size is proportional to accumulated savings. Therefore, peer pressure works to shield default risk as well as to persuade clients to save. The accumulated savings are also used for credit extension. This may also lead the village bank to become self-sustaining by accumulating its internal capital.

Credit Union: Credit unions are non-profit co-operatives formed by a group of people who have a common bond. Members of the group/co-operative control the union by themselves and offer services ranging from saving mobilisation to credit extension and their recoveries. However, credit unions are generally linked to some apex body that supervises, provides them training, and monitors their performance.

Self-Help Groups: As the name indicates, this model is group based where people belonging to similar income brackets join together and forms a group. These groups are generally self-sustainable implying that all members pool their savings and then this pool of saving is used to extend credit. These groups can also seek external funding if they wish to. Members of the group decide among themselves about terms and conditions of all products/services they have agreed to offer to each other through this arrangement.

11.2 Structures of Islamic microfinance

Islamic microfinance instruments will be discussed under two main categories: [4]

1. Charity based microfinance instruments
2. Profit based microfinance instruments

11.2.1 Charity based MF instruments

The target group of this category is the extremely poor, economically inactive, and in need of consumption funds for the basic necessities of life: food shelter, health, etc. However, it is crucial to make them economically active by providing some training or equipping them with technical skills making their social and economic uplift sustainable. The instruments for this group may be classified in following two broad categories:

a) Zakah, sadaqa & waqf

The Islamic economic system encourages helping the extremely poor and destitute to meet their basic necessities of life, and in this regard, sadaqa, zakah and waqf are three significant instruments of extending social safety nets. Zakah, one of the five pillars of Islam, is an obligatory, annual payment of a prescribed proportion of one's wealth. Sadaqa on the other hand is not obligatory, and varies in form and quantity. These funds are not certain as they are dependent on one's desires. Funds collected under these two instruments can, however, be utilised as subsidies or charity funds for the poorest that are not served by conventional microfinance.

The Islamic economic system encourages people to help the poor and promote economic empowerment while discouraging the over dependence on subsidies and donations. Islamic microfinance, ideally, cannot rely on the assistance of charities alone; it also requires working for the economic empowerment of the poor. Waqf according to Mufti Taqi Usmani "is a legal and religious institution wherein a person dedicates some of his properties for a religious or a charitable purpose."[5] It can complement sadaqa and zakah. Like sadaqa, waqf is not an obligation, however, it is stable and sustainable once it is implemented, and may be used to provide technical skills or trainings to the poor and economically inactive groups. However, sustainability becomes challenging and institutions are required to combine these charitable instruments with profit based instruments.

b) Qard hasan

Qard hasan, an interest free loan, is considered the purest form of Islamic financing to help the poor. The essence of this instrument is that the borrower only pays back the principal amount, again with the objective of helping the very poor segment of population. For MFIs, this instrument may be used for both saving and financing purposes. As it is zero return financing, it can be used to provide microfinance to the needy for either consumption or investment, and the borrower will only pay back the principle amount. However, it is pertinent to mention here that the lender or lending institution can cover the operational cost from the borrower. Along with being a zero return financing facility, this product has the flexibility of allowing extension in the repayment of loan amount thus helping the borrower avoid being stuck in a debt trap, which is one of the major lacunas of conventional microfinance especially in bad times (involuntary default of borrower).

[3] Obaidullah, M. & Khan, T. (2008) "Islamic Microfinance Development: Challenges and Initiatives" Policy Dialogue Paper No. 2, Islamic Research and Training Institute (IRTI)

[4] Obaidullah, M. (2008) "Introduction to Islamic microfinance." International Institute of Islamic Business and Finance.

[5] Usmani, T. (2001) "Introduction to Islamic Finance" CQ Press

Another characteristic of this instrument is that there can be no specific date of redemption making it an eligible as a savings product, as depositors can deposit their saving and can withdraw whenever they are in need.

Akhuwat, in Pakistan, is using qard hasan in its unique community based model (Case Study 1) to extend microfinance. Islamic microfinance institutions in Afghanistan are also using this product while in Indonesian, Islamic microfinance institutions are using an array of products including zakah and qard hasan.

even with the agency agreement, the seller carries the ownership risks, which could be physical or contractual, but can be minimised through takaful (insurance). It is worth mentioning here that an Islamic MFI, ideally, should not adopt the agency agreement particularly with the client to encourage economic activity in order to generate further employment. In this regard Wasil Foundation (formerly known as the Centre for Women Co-operative Development) in Pakistan is an example of an Islamic microfinance model where murabaha is being offered without any agency agreement.

Moreover, murabaha to purchase order is a one sided undertaking implying that the client may withdraw

Case Study 1: Akhuwat Microfinance Model

The Akhuwat microfinance model is a unique model whose inspiration stems from the concept that Muslims are brothers, and shall help each other. The model is based on the concept of community solidarity where services are offered through places like mosques and churches – the most visited places for members of the community. Akhuwat provides individual or family loans without collateral on the basis of qard hasan. Social collateral, where the community guarantees the borrower, is the basis for extending financing under this model. However, to cover the management cost, Akhuwat secures funds from civil society along with borrowers contributing to the fund. Borrowers' contribution to the fund is purely voluntarily. The community brotherhood philosophy encourages borrowers to contribute, indirectly inducing them to save. This contribution fund along with some donation is used to cover the administration cost.

11.2.2 Profit based microfinance instruments

i) Financing modes

a) Murabaha

Murabaha is the most popular Islamic financial product and also has great potential in microfinance. The Islamic MFI buys assets from the seller for its client and then sells the asset to the client at a predetermined profit margin. The payment of the client can be a lump-sum or in installments at some agreed upon future date(s). It is critical that both parties know the price and cost for this transaction thereby minimising the probability of exploiting the client because of information asymmetry. One major criticism that conventional microfinance is facing is the exploitation of clients by levying exorbitant interest charges because the targeted clients are not sufficiently aware of the market and its practices.

Under this structure the client is not required to maintain any record once the transaction is completed - although documents evidencing purchase during the transaction is fundamental - making it a useful product for small businesses. Fulfilling stringent documentary requirements can discourage institutions from taking financing from these formal institutions and exposing them to exploitative money lenders.

From the MFI's perspective, there is an additional risk in the product - the ownership risk - from the time the MFI buys the product from the seller till he sells it to the client. Practically, like other Islamic financial institutions, the Islamic MFI signs an agency agreement with a third party to purchase the asset from the supplier on his behalf. This third party may be the client. However,

purchase of the asset; however, this risk can be minimised through advance payment (himish jiddiya). To target default risk, the lending institution may ask for collateral. In case of microfinance, it may be difficult for clients to provide collateral and therefore the Group Lending Model (see above) is adopted where the group works as collateral just like it works for conventional microfinance.

Islamic MFIs are predominately utilising the murabaha in Malaysia.

b) Mudaraba and musharaka

These are partnership based modes which explicitly differentiate Islamic microfinance from conventional microfinance. Mudaraba implies trustee financing where two parties form a partnership in a way that funds are being provided by one (rab-ul-mal) while managerial skill is being provided by the other (mudarib) in execution of a project. Under the mudaraba the profits are shared based on pre-agreed ratios while, in case of loss, the financier party - the MFI - bears the loss of capital unless and until the loss occurs due to negligence and misconduct of the mudarib. Islamic MFIs may use this product to improve the social status of its client by providing them the security of finances and enabling them to take risks involved in a business. As an institution provides financing that will work as an effective force for the institution to be vigilant in monitoring of the business/venture thus reducing the risk of losses as well as pushing the client to improve their managerial skills.

Mudaraba and qard hasan were main products of Islamic microfinance during the 1980's when Islamic microfinance was initiated in Sudan. Bangladesh, one of the leading markets for Islamic microfinance, is also using mudaraba as a key mode of financing.

In musharaka, both parties (financier and client) share in capital as well as managerial, and thus share the profit according to a predetermined rate set at the time of contract. Loss sharing is strictly in proportion to the invested capital. This product can be ideal for an Islamic MFI as the financier will not only provide financing but will also help in managing the business ventures. For small enterprises which are unable to have access to finances, and are also faced with a lack of entrepreneurship skills, this product can serve dual objectives. The product may equally be attractive to the MFI as it will be directly involved in the operation of business, therefore monitoring and supervision will be quite effective reducing both voluntary and involuntary default risks. However, the MFI is exposed to risk of capital impairment though this risk can be minimised through third party guarantees, such as that offered by the Credit Guarantee Corporation in Malaysia.

For Islamic microfinance, these two modes appear most appealing; however, they are not very popular due to uncertain cash flows, moral hazard, adverse selection, long term involvement and high costs for both the institution and the client in meeting additional requirements of producing formal documentation and accounting procedures, etc.

Yemen is an example of running Islamic microfinance on the basis of musharaka.

c) Diminishing musharaka

This is a form of musharaka where the ownership share is gradually transferred from financier to client. Under this contract, the share of the Islamic MFI in equity diminishes gradually. It receives profit in proportion to the share which is still invested in the business venture during the period. Consequently, the share of the client increases with time, and at the end of the contract the ownership of the asset/venture is completely transferred to client.

d) Salam and istisna

Salam is generally agriculture-specific and istisna is manufacturing-specific financing modes in which contracts are executed to meet short term financing needs of clients. Under salam, the client who may be a farmer or a small trader sells his crop/output to the MFI for spot payment to meet his financing needs while the delivery of output is agreed upon to be made for some specific future date. The product is structured so that the spot price is lower than the future price of the delivered item. For microfinance clients, salam is a useful mode, and it has been recognised that the targeted class contains a significant portion of clients that are in need of short term financing only. The structure of istisna is like salam but focused on manufacturing products with the flexibility of partial payments by the financer.

Under these structures, the MFI is exposed to default risk, as the client may be unable to deliver the commodity in the future. This risk can be minimised through takaful. The institution is also exposed to the risk of price fluctuation (market risk) since the future price may fall below the price at which the MFI bought the commodity from the client because of unexpected events.

Case Study 2: Wasil Foundation Model

Wasil Foundation's use of salam in Pakistan can be judged as one of the best, practical examples currently in the market. The uniqueness of the Wasil Foundation microfinance model is that the organisation is offering all its products (salam, murabaha and ijara) without the usage of an agency agreement suggesting that the organisation is actually involved in trading, and is taking possession, ownership, credit and market risks in its true sense. To provide financing to farmers at the time of harvest, the organisation, using the salam, buys their crop at a pre-agreed rate and then sells the crop in the market itself instead of selling it back to the client under the agency agreement.

ii) Rental models (ijara)

Ijara is used by the MFI in order for the client to benefit from the usufruct from the income generating assets for a certain payment, the rate and intervals of which are predetermined. Under this mode, the MFI permits clients to utilise the asset for his/her benefits against rent while the ownership remains with the institution. Ijara is a contract for a specific duration, at the end of which the institution may gift or sell the asset to the same client. As the ownership of asset remains with the MFI, the institution is obligated to take on all risks and liabilities, which is significantly different from conventional leasing making it a more attractive option for microfinance clients.

Under ijara, the institution is exposed to possession risk: in case of damage or destruction to the asset, the institution is liable for all damages, and not the client, unless this loss has occurred due to negligence of the client. However, the institution can hedge itself from this risk through takaful.

iii) Saving products

In general, saving products are offered under three modes: (i) wadia (ii) qard (iii) mudaraba. These products may be used to encourage the microfinance client to save even smaller amounts as they are allowed to withdraw whenever they want, and there is no risk of loss.

Under mudaraba, the transaction structure is the same as has been discussed above. The only difference is that the client becomes the rab-ul-mal while the MFI acts as mudarib. Under this mode, the client is exposed to investment risks (in case of loss, all financial loss is borne by the rab-ul-mal) and shares the profit with the institution on a pre-determined ratio.

iv) Takaful

Takaful, is one of the most important products for clients of MFI institutions as, generally, this group is unable to plan or save for unexpected or uncertain events in the future. Takaful, ideally, is a non-profit mode where all the participants provide joint guarantees. Under takaful, a joint fund is formed by contributions of each participant and the fund money is then used to support/ help any member of the contributing fund in difficult times like death, sickness, crop or business loss, etc.

11.3 Composite Islamic microfinance model

To fully capitalise on the essence of Islamic microfinance, the ideal model would combine charity based instruments with profit based instruments. For this purpose, Islamic MFIs may offer differentiating products to classify varying levels of poverty. Salient features of each product can guide its suitability for a certain poverty level segment. Another distinguishing feature can be a microfinance program with various phases that will help in ensuring the utilisation of financing and sustainability of improvement in the social uplift of the microfinance client.

As Figure 1 explains, three phases can be defined for one programme in which the abject poor would be eligible to become clients for Phase-1 where they would be provided with the basic necessities of life. For this purpose, funds collected under zakah and sadaqa will be used. However, the mandatory requirement of this phase would be impartation of technical and entrepreneurship skills for clients which can enable them to be economically active. Vocational training and skill enhancement services will be offered through waqf. These clients would become eligible for Phase-II once they reach income level Y1, which is the segregating level between the bottom poor and mid-level poor, generally termed chronically poor. This segregation of income levels can also be estimated using poverty score cards.

The chronically poor will be the target client base of Phase-II, which though economically active compared to clients in Phase-I, are not able to sustain it. Qard hasan may be used to provide financing in this phase and saving products can also be offered under the same mode. The advantage of qard hasan is that financing under this mode can be extended for both consumption and investment purposes. Training for skill enhancement would again be a mandatory requirement for Phase-II, and will be provided using waqf.

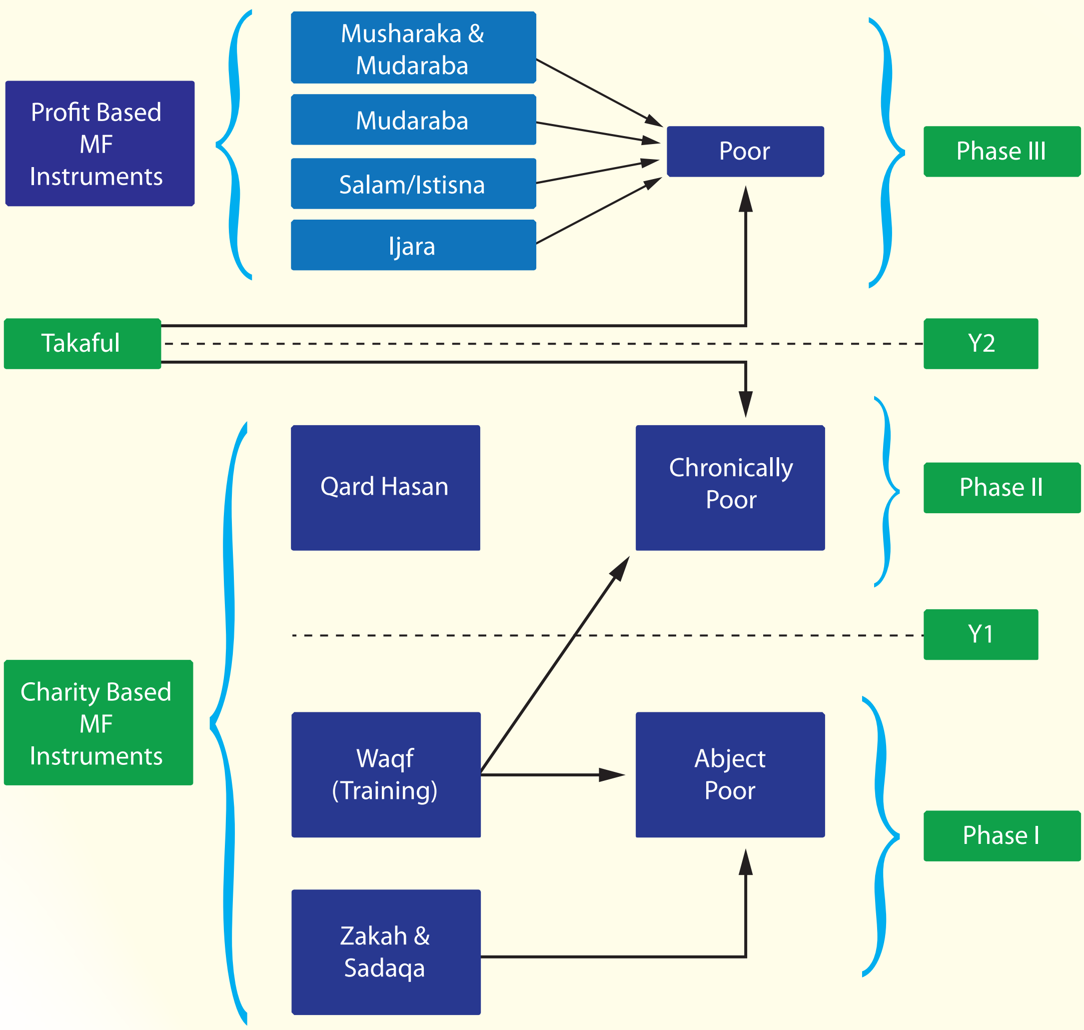

Figure 1: Composite Islamic Microfinance Model

Y2 will be the threshold to become eligible for Phase-III where all profit based instruments can be offered and clients may choose according to their requirements. Training for skill enhancement will be offered as one of the services to clients in this category. Takaful will be offered to all in Phase-II and Phase-III.

On the funding side, saving schemes can also be launched. This saving scheme can be voluntary for clients in Phase–I and Phase–II while for Phase-III clients monthly contribution amounts can be specified. Funds can be used for extending financing particularly for clients in Phase-II using qard hasan while this will also help in encouraging that particular segment to save. The Farz Foundation model (Case Study 3) is an interesting example of a composite microfinance model.

Case Study 3: Farz Foundation Model

The Farz Foundation model is innovative. Since its inception, it has encouraged its members to save. This saving practice is based on the idea of a community rotating fund (generally known as committee) where members are obligated to pool some specific amount on a monthly basis. This pool of saving is used to extend credit to one member or another. Moreover, this model is composite as it offers a range of products subject to varying income levels and is also focused on managing the total value chain. In broader terms their products can be divided into four main categories:

i. For the poorest, Zakah or charity in kind or in shape of income generating tools + health care awareness + business & environmental education.

ii. For the moderately poor, small murabaha + takaful + committee (participatory saving) + health care awareness +business & environmental education.

iii. For the poor medium, murabaha + takaful + committee (participatory saving) +health care awareness +business & environmental education.

iv. For the non-poor large, murabaha + takaful + committee (participatory saving) + health care awareness + business & environmental education.

Farz Foundation also has a focus on agriculture and micro businesses for their second and third categories, while for the fourth category their focus is on small and medium enterprises (SMEs).

11.4 Conclusion

Microfinance cannot be separated from Islamic finance if targeting the ultimate objective of social welfare enhancement by promoting inclusive growth and encouraging wealth distribution. Structures of Islamic microfinance have got inherent checks, and ability to deal with varying levels of poverty while providing foundations for the sustainability of institutions. However, the presence of Islamic microfinance is still very low and is concentrated only in few countries depicting a huge potential market for Islamic financial institutions as well as microfinance institutions to capture the faith sensitive microfinance clients.